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More than ever, outsource contracts need to be solid

A recent survey reported in CFO Magazine reflects that more than half of financial executives in the United States say the country is now in a recession, and another quarter believe the country will be in recession by the end of the year. Many respondents cited tightening credit availability as a source of concern throughout the supply chain for their businesses.



INSIDER VIEW

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In this economic climate, businesses planning to outsource or subcontract functions to third-party providers should focus on “bankruptcy-proofing” their contracts.

Even if your outsourcing contracts are reflected as accounts payable on your general ledger, any decision to outsource infuses additional credit risk into the business. When a provider’s checks bounce, its suppliers are likely to look to you for payment even though you already funded the provider for those expenses. If your general contractor stops paying its subcontractors, mechanic’s liens may attach to your leasehold and your landlord will give notice that you’re in breach of your lease. For this reason, there should always be a compelling business reason for undertaking the risk of outsourcing. We recommend the following guidelines to clients considering outsourcing:

- Do your due diligence. This should include a financial as well as an operational review. Including harsh remedial provisions in a contract, while perhaps advisable in the abstract, is of little value if the defaulting service provider has no assets and cannot pay damages.

- Facilitate a quick exit when bankruptcy

looms. Build into your contracts “early warning” systems designed to detect financial distress, such as regular financial reporting requirements and change of control provisions. Where feasible, a short contract term with renewal options provides more protection than a multiyear term. The key is to allow flexibility to terminate a contract quickly before a bankruptcy filing.

- Don’t count on bankruptcy termination clauses. One contract provision that may not be helpful is the so-called “ipso facto” clause, which allows termination for default based upon a bankruptcy filing. Such clauses are generally unenforceable, since bankruptcy imposes an “automatic stay” that prevents termination of a debtor’s contracts. Bankruptcy termination clauses may be useful for limited purposes, provided that their limitations are understood. Defining a bankruptcy filing as an event of default usually will not permit the contract to be terminated, but may trigger a right to payment or performance by a solvent guarantor.

- Obtain credit enhancement. Wherever possible, seek credit enhancement in the form of insurance, standby letters of credit, blanket lien bonds or surety bonds, or third-party guarantees. Ask the service provider to agree that, in the event of default, you may make demand on third party guarantors and sureties, or draw down on letters of credit, without giving notice to the service provider. This enables you to take advantage of credit enhancement devices without running afoul of the “automatic stay”.

- Preserve setoff rights. Include in your contract express authority to “set off”, or withhold, payments to the provider as security for any right to payment the provider may owe to you. If the provider files for bankruptcy protection, you will need to request relief from the bankruptcy court to

exercise this right, but including this provision in your contract will go far to persuade the court to grant that relief.

- Protect intellectual property. Intellectual property issues pose particular risks in the event of insolvency or bankruptcy. Bankruptcy law contains particular provisions designed to protect the rights of non-debtors, such as software licensees, but taking full advantage of these protections requires advance planning.

- Include nonfinancial obligations. Federal bankruptcy law gives a debtor rights to assign and sell its contract rights — even over strenuous opposition by the other contract party. Those rights, however, may be circumvented if the service provider has failed to perform obligations under the contract that cannot be “cured” after the fact. By building into the contract various nonfinancial obligations and measures of performance, you may anticipate and strengthen your argument against an undesirable contract assignment.

- Plan for contingencies. Always have a contingency plan in place to anticipate what will occur if a provider of critical services fails to perform for any reason. The plan should identify who will perform the service, whether it can be performed in-house or by other providers, and it should include a detailed transition plan as part of the contract.

Businesses seeking to outsource services in today’s economy should anticipate the risk that a service provider may be caught in the credit crunch. Consult with experienced bankruptcy counsel to ensure that outsourcing contracts are properly drafted so as to anticipate and plan for these risks.

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